FedFin Daily Briefing

Monday, February 3, 2020

FRB-NY Study: Big-Bank Complexity Dropped, What's Left Might Be Beneficial

Late last week, the Federal Reserve Bank of New York released a staff paper finding that, from 2007 to 2017, organizational and geographic complexity at large U.S. banks dropped and business complexity shifted at the biggest banks due to greater concentration in portfolio management and a drop in financial intermediation. Organizational-complexity reductions are most pronounced at the largest banks, principally due to consolidation in domestic operation. Non-financial business has shifted to a greater focus on housing-related activities. The largest U.S. banks have retained or increased geographic presence in tax-haven states, but derisked by reducing operations in emerging or opaque regimes.

As several new Fed staff research papers we will shortly assess emphasize, these findings are significant in terms of the goals of post-crisis resolution planning and the GSIB surcharge, both of which penalize complexity, especially when size has also increased. However, in recent weeks, U.S. policy has become more tolerant of complexity, with the proposed changes to the Volcker Rule and FRB control standards (see Client Report **TAKEOVER9**) increasing organizational and business complexity with potential geographic impact. The paper notes that, despite fears about large banks being "too complex to manage," diverse business lines and geographic dispersion add value, synergy, diversification benefits, and efficiency. It thus calls for greater research on complexity's impact on individual BHCs and the broader financial system to differentiate complexity's benefits from risks such as resolution challenges, agency incentives, and moral hazard.

FHFA Targets FHLB Acquired Member Assets

Continuing its policy of curtailing GSE product offerings that could compete with the private sector, the FHFA today has released an advisory bulletin instructing Home Loan Bank boards quickly to set limits on acquired-member-asset (AMA) programs. The bulletin acknowledges that AMA mortgage programs are consistent with the FHLB mission, but states that owning a mortgage involves risks beyond those in advance activities. Price risks are a top concern as is compliance with affordable-housing goals. Interestingly, FHFA targets AMA programs that "disproportionately" buy from a single member, one of the few cases of FHFA action on System concentration risk and perhaps a prelude to action on a larger concern: rollover risk resulting from concentrated advance borrowings.

FRB Staff: GSIBs Window Dress One GSIB Indicator

New research from FRB staffers examining ways U.S. GSIBs might minimize GSIB surcharges (see FSM Report **GSIB7**) concludes that window dressing has occurred in only one systemic indicator category, but that window-dressing within this category is significant. GSIBs principally

reduce only one systemic importance indicator: the notional amount of OTC derivatives, doing so in sizeable amounts during the fourth quarter of each year when the FRB sets the surcharge. The issue of window dressing has become a hot topic in the wake of repo-market turmoil, with banks arguing that the GSIB-surcharge methodology exacerbates other regulatory pressures to eschew repo exposures. The FRB has so far taken no action to address this, although senior staff has suggested that the methodology will be changed to averaging or a different approach to prevent quarter- and year-end stress.

This study does not support assertions that exposure or inter-connectedness indicators are being window-dressed in ways that might adversely affect the repo market. To reach the surcharge-arbitrage conclusion, the study observed that this adjustment is found to be stronger at GSIBs than other banks; OTC derivatives held by GSIBs drop thirteen percent relative to non-GSIBs at year-end. This impact became more pronounced after the introduction of the surcharge in 2016. Changes in GSIBs' notional amounts of interest rate swap and forward contracts were the main drivers of the drop, with swaps dropping ten percent and forward contracts falling 24 percent relative to non-GSIBs. The change in the notional amounts of interest rate options was not statistically significant. The authors argue that compression of OTC derivatives is an especially attractive method of reducing systemic indicators because it allows banks to eliminate redundant contracts while keeping market risk unchanged.

IMF Study Finds Fintech Financial-Stability Benefits, We're Not So Sure

In this alert, we assess a new IMF staff paper finding that fintech adoption is likely to increase financial stability by enhancing borrower monitoring and screening. While the paper makes broad conclusions about fintech's impact on financial stability, it only assesses the impact of U.S. bank technology adoption on non-performing loans (NPLs) during the crisis. It acknowledges that pre-crisis technology "might" be different than modern AI/ML techniques, but then suggests that that current techniques are just more powerful versions of pre-crisis statistical models. The study defends its focus on the crisis-era by noting that current fintech firms have not yet been subject to systemic shocks. We would note, however, that fintech a decade ago was in its infancy and was characterized by different products, methodology, and structure. The paper is also silent on fintech's connection to nonbanks and the room for regulatory arbitrage.

The study finds that higher information technology adoption is associated with having 10 percent fewer NPLs and a 16 basis points lower NPL to assets ratio in the years between 2007 and 2010. Information technology is measured using the ratio of personal computers per employee within a branch, with bank-wide effects estimated after controlling for branch size and location. This measure does not to us indicate whether a bank is in fact more technologically adept, which might better be measured by how PCs are used rather than by their number.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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High- and low-technology-adopters were found to have the same geographic and business model exposure to the crisis. Mortgages sold by high-tech banks to Freddie Mac were significantly less likely to be delinquent during the crisis than those sold by other banks, causing the paper to conclude that high-tech banks were better at screening loans, not better at offloading their bad loans to GSEs.

The study also concludes that technology adoption reduced overall financial stability risks because high-risk individuals, who were rejected by technology adopters, did not borrow from nearby low-tech banks. Results are consistent after controlling for the credit-scores, DTI ratios, and LTV ratios of borrowers, leading the paper to conclude that high-tech banks had either additional information or used these variables in a more sophisticated manner. The study also finds that banks led by "tech-oriented" executives adopted more technology and had fewer NPLs during the crisis. Tech-orientedness is measured by the number of tech-related keywords in bank CEO biographies.

HFSC to Advance Targeted National Usury Cap

As part of its Wednesday hearing on "rent-a-bank schemes," HFSC will consider legislation (H.R. 5050) that would impose a 36 percent usury APR cap on certain consumer loans. Unlike the similar bills HFSC considered last April, Rep. Garcia's (D-IL) bill is targeted at payday and car-title loans, exempting mortgages, auto-purchase loans, and loans originated by credit unions. The CFPB would be barred from exempting additional transactions. The legislation would not preempt stricter state laws and would allow enforcement by state Attorneys General. The bill is in part intended to address concerns that the OCC and FDIC "valid-when-made" proposals (see FSM Report **PREEMPT31**) would enable predatory lending. Senate Banking Ranking Member Brown (D-OH) is a co-sponsor of the Senate companion (S. 2833). We will provide clients with an in-depth assessment of the HFSC hearing.

Big Banks Found Safer Except re Liquidity Risk

The Federal Reserve Bank of New York blog today examined large U.S. BHCs since the financial crisis, confirming Fed assertions that these companies have changed their ways but finding troubling indications of elevated liquidity risk. Idiosyncratic, liquidity, systematic, and systemic risk increased sharply during the financial crisis and the years immediately following it; all of these risks but liquidity have fallen back to or exceeded their lows prior to the lead up to the crisis. Large banking organizations appear to be riskier due to liquidity risks triggered by general stress in funding markets, with liquidity risk increasing in the second half of the last decade after decreasing and then stabilizing in the immediate aftermath of the crisis. The blog post defines systematic risk as the component of risk that is not diversifiable relative to the overall stock market; idiosyncratic and systemic risk track their common usage.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing requests@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about GSE Activity Reports, click: http://www.fedfin.com/index.php?option=com_content&view=article&id=18&Itemid=18

- **GSE-020320:** FSOC has added nonbank mortgage origination and servicing to the official systemic hit list and FHFA and the GSEs under its control have now acted not only to address some of these concerns, but also longstanding ones about Ginnie Mae's vulnerability to its mortgage mainline.
- **GSE-013120:** As anticipated, the FDIC finalized a controversial proposal, issuing a final rule eliminating a problematic disclosure requirement in the 2010 safe-harbor rule.
- **UDAP6:** Finally tackling one of the most controversial issues in its 2014 enabling statute, the CFPB has issued a policy statement defining when it is likely to consider consumer-finance practices "abusive" subject to supervisory or enforcement action.
- **PAYMENT19:** In this report, we assess the HFSC fintech task force hearing considering legislation (H.R. 2650) to prohibit retail businesses from refusing or penalizing cash payments.
- **TAKEOVER9:** As anticipated, the FRB and FDIC approved a controversial proposal joined by the OCC, SEC, and CFTC to expand the covered funds banks may own or support under the Volcker Rule.
- **CRA27:** In this report, we assess today's heated HFSC hearing with Comptroller Otting on the OCC and FDIC CRA proposal.
- **GREEN:** In this report, we assess the comprehensive policy paper on green financial policy released by the Bank for International Settlements (BIS).
- **CRA26:** Reinforcing its commitment to the controversial proposal to rewrite the Community Reinvestment Act (CRA) rules it issued with the FDIC, the OCC seeks bank-specific data over the past three years on several questions fundamental to understanding the implications of the proposed approach on both banks and low-and-moderate income (LMI) communities.
- **GSE-011520:** Reflecting Democratic demands that the GSEs fund the affordable-housing trust fund regardless of earnings, senior House Democrats have introduced H.R. 5599 to capture the contentious 10 bp G-fee add-on.

Federal Financial Analytics, Inc.
2101 LStreet, N.W. – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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